FISCAL NOTE

Bill #: HB0760 **Title:** Sales tax and repeal of income tax

Primary Sponsor: Mcgillvray, T **Status:** As Introduced

Sponsor signature Date David Ewer, Budget Director Date

Fiscal Summary

	FY 2006 Difference	FY 2007 Difference
Expenditures:		
General Fund	$0	$2,750,000
Revenue:		
General Fund	$0	$0
Net Impact on General Fund Balance:	$0	($2,750,000)

☐ Significant Local Gov. Impact	☒ Technical Concerns
☐ Included in the Executive Budget	☒ Significant Long-Term Impacts
☐ Dedicated Revenue Form Attached	☒ Needs to be included in HB 2

Fiscal Analysis

ASSUMPTIONS:

In general, this bill provides for repealing the state individual income tax and implementing a general retail sales tax effective January 1, 2008. Because of the delayed implementation date, there is no revenue impact from this proposal in the 2007 biennium. See the long-range impacts section of this fiscal note for impacts in future years.

ADMINISTRATIVE IMPACTS

1. The Department of Revenue would require an information system to administer the sales tax proposed in this bill. Construction of the system would have to begin in FY 2007 to implement this tax by January 1, 2008. The estimated expense for contracted services in FY 2007 is $2.750 million. This represents one-half of the overall system cost.

FISCAL IMPACT:

	FY 2006 Difference	FY 2007 Difference
Expenditures:		
Operating Expenses	$0	$2,750,000
Funding of Expenditures:		
General Fund (01)	$0	$2,750,000
Net Impact to Fund Balance (Revenue minus Funding of Expenditures):		
General Fund (01)	$0	($2,750,000)

EFFECT ON COUNTY OR OTHER LOCAL REVENUES OR EXPENDITURES:
None.

LONG-RANGE IMPACTS:
The long-term impact on the state general fund will depend on the relative amounts of revenue that would be collected under the current state individual income tax versus the amount of revenue that would be collected under the proposed general retail sales tax. Revenues to the state general fund will decrease to the extent that future sales tax collections are less than future individual income tax collections, and will increase to the extent that future sales tax collections exceed future individual income tax collections. Following sections discuss the impacts of this proposal on individual income tax and sales tax collections in future years.

INDIVIDUAL INCOME TAX

1. The state's individual income tax is repealed effective January 1, 2008. After this date, there will be no withholding or quarterly estimated tax payments made that otherwise would be made under current law for tax year 2008 in FY 2008.
2. Individual income tax collections for FY 2008 would include one month's worth of withholding for taxpayers on a monthly withholding basis, one week's of withholding for taxpayers who file under the accelerated withholding filing schedule, and would also include the payments made by annual filers. Taxpayers making quarterly estimated tax payments would make one payment in FY 2008 related to tax year 2007 liabilities. FY 2008 revenues would also reflect the net impact of tax year 2007 filings (refunds versus payments on returns) during the period January 1 through fiscal year end.
3. The above assumptions result in an estimated net reduction in individual income tax revenue of $343.731 million in FY 2008. Eliminating the individual income tax is estimated to reduce general fund collections from this source by $681 million in FY 2009.
4. Under this bill, the current law refundable elderly homeowner/renter credit against individual income taxes is not repealed, but is converted to a state payment program, rather that a credit program.

GENERAL RETAIL SALES TAX

5. Beginning January 1, 2008, this bill would impose a 4% sales and use tax on retail sales of tangible personal property and services, except for the tax on accommodations and campgrounds which would continue at the current law rate of 3%. The bill provides for the following exemptions: sales of real property and improvements; sales for resale; inputs used in manufacturing; health services included in NAICS sector 62; educational services included in NAICS Sector 61; agricultural, forestry, fishing and

hunting services included in NAICS Sector 11, except hunting and trapping; non-retail sales by individuals engaged in agriculture, forestry, fishing and hunting; medicine, durable medical equipment, mobility enhancing equipment, and therapeutic and prosthetic devices; motor fuels; business equipment subject to property taxes; insurance commissions and premiums; dividends and interest; transportation except for unscheduled air passenger transportation, truck transportation, surface passenger transportation other than transit, school and employee transportation, and pipeline transportation; farm product warehousing and storage; services by an employee for the employee's employer; services a corporation provides to an affiliate or subsidiary that is centrally assessed; gambling; sales by or to a government or tribe; sales of utility services and telecommunications services; unprepared food; prepared food that is part of a residential or health care arrangement; agricultural inputs including feed and fertilizers; services for livestock; sales or lease of mineral interests; minerals or chemicals used in processing ores; sale of inputs for use in mining or manufacturing; rent or lease of a dwelling other than a mobile home; lease or rental of a mobile home for more than 1 month; interstate sales if the product or service is used entirely outside the state; radio and television broadcasting to the extent tax prohibited by federal law; and sales of tangible property for leasing.

6. Sales tax will be collected for the second half of FY 2008. It is estimated that sales tax collections after controlling for noncompliance and net of vendor allowances during this period will total $205.243 million.
7. FY 2009 gross liability for the sales tax is estimated to be $546.454 million. Noncompliance would reduce collections by 5% of this amount, or by $27.323 million in FY 2009. There would be approximately 55,000 businesses collecting the tax on their sales. The bill provides for a vendor allowance of 5% of sales not to exceed $350 per month. Total vendor allowances would be $45.139 million in FY 2009. This results in net sales and use tax collections, before sales tax administration costs, of $473.992 million in FY 2009.

NET IMPACT

8. Based on the above assumptions, it is estimated that this bill would reduce general fund revenues by $138.488 million in FY 2008, and by $207.008 million in FY 2009.

LONG-TERM ADMINISTRATIVE EXPENSES

9. The Department of Revenue would incur cost increases beginning in FY 2008 to administer the sales tax proposed in this bill and reductions in current operating costs in future years with the phase-out of the individual income tax.

OTHER LONG-TERM IMPACTS

Passage of this bill would significantly increase *federal* individual income tax liabilities of many Montana taxpayers; primarily high-income taxpayers. Under current federal law taxpayers may deduct their state individual income taxes when calculating federal tax liability. Eliminating the state individual income tax would act to increase federal individual income tax liabilities of Montanans by as much as $130-140 million a year.

The federal government has provided a two-year window of opportunity – *a window that closes before the effective date of this bill* – that allows residents of states without an individual income tax to deduct sales taxes in lieu of the deduction for individual income taxes. If Congress extends the ability to deduct sales taxes, Montana taxpayers who itemize deductions for federal income tax would have smaller deductions for state taxes with a state sales tax than with a state income tax. This would be particularly true for high income households. This would result in a significant increase in federal individual income tax liabilities for many Montana taxpayers.

TECHNICAL NOTES:

1. Section 14 of the bill amends 15-1-501, MCA to remove reference to the disposition of individual income tax revenues to the state general fund effective January 1, 2008. However, there will continue to be collections of revenue from the individual income tax well after the effective date of the bill. This section should be amended to read that collections of income taxes that continue to occur after the effective date of the bill should be deposited in the state general fund.
2. Section 55 (19) provides a definition of grooming and hygiene products that includes those meeting the definition of over-the-counter drugs. However, the definition in Section 55 (25) indicates over-the counter drugs does not include grooming and hygiene products.
3. Section 56 (a) indicates the tax rate is 4% on all sales of services and tangible personal property, however, part (b) indicates the tax rate is 3% on accommodations and campgrounds. There should be language indicating the rate is 4% except for the rate on properties as provided in part (b). The same comment applies to Section 56 (3)
4. Section 56 (5) states "the sale of property or services exempt or nontaxable under this chapter is exempt from the tax imposed in subsections (1) and (3)". There is no language however, referring to the similar use of exempt property.
5. Section 60 addresses incorrect claims made with the intent to evade but does not address claims made in error. Additional language should be added to indicate the purchaser is liable for payment of the tax due for which the purchaser incorrectly claims an exemption.
6. Section 62 exempts certain types of services from the sales and use tax. It defines those services with reference to the North American Industry Classification System (NAICS). The NAICS manual contains definitions of industries, not of goods and services. For example, subsection (a) exempts health services and cites NAICS sector 62. NAICS sector 62 consists of establishments whose primary function is providing health care and social assistance, but these establishments also sell a variety of other goods and services. For example, many hospitals have cafeterias or snack bars and gift shops. This fiscal note assumes that the exemptions in Section 62 are for sales in the primary lines of business that define the NAICS industries referenced, not for all sales by establishments in those industries. The NAICS industry classification system was developed by the Census Bureau and its counterparts in Canada and Mexico. The agencies are in the process of developing the North American Product Classification System (NAPCS), which will be a classification system for goods and services. Preliminary NACPS definitions are available for some types of goods and services. Section 62 should reference NACPS definitions where they are available. Otherwise, the bill should provide definitions or leave definitions to the rulemaking process.
7. Section 62 (1) provides taxation of fishing, hunting, and trapping however, the majority of services in this NAICS Sector 114 are not provided through a traditional retail transaction and the tax would be difficult to enforce. Services more suitable to tax administration, such as outfitting, charter fishing, hunting camps, and guides, are included in other NAICS sectors not in Sector 114.
8. Under Section 62 (ii) truck transportation and (iv) pipeline transport are taxable, however the Commerce Clause prohibits taxation of interstate transport of goods.
9. Section 62 (g) misidentifies security brokerage (NAICS 52312) as part of NAICS Sector 48.
10. Section 73 exempts unprocessed agricultural products however some products are sold directly to the end-user for immediate consumption.
11. Section 62 and Section 69 appear to be redundant. Section 62 exempts the security brokerage industry and Section 69 exempts commissions or fees from brokerage services.

12. Section 61 and Section 76 appear to be redundant as both exempt property purchased as an input for manufacturing.
13. This bill exempts personal property subject to taxes under 15-6-138, MCA (Class 8). However, new industrial property, equipment used in research and development, and pollution control equipment is in Class 5 not in Class 8. It is not clear if it was the intent of this bill to exclude this property from the exemption.
14. This bill repeals requirements that income tax returns be confidential. It is not clear that income tax returns for years before the effective date of this bill would remain confidential.